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## CONTENTS





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# EU CONVERGENCE, STRUCTURAL ADJUSTMENTS AND GROWTH: IS SEE6 CATCHING UP?

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**Abstract**

During the past decade, ten new EU member states reached a high degree of market integration and macroeconomic stabilization as part of their accession process. The main challenge for these countries is to deal with large and potential volatile capital inflows and to achieve nominal convergence needed for adopting the euro. These challenges must be addressed within the scope of the limited fiscal policy. In the context of macroeconomic adjustment, macro-fiscal policies will be in the focus of macroeconomic policies in the years that follow.

They need to focus on meeting the requirements for sustainability of EMU, and to assist in absorbing the effects of aggregate demand of large capital inflows. So in terms of macroeconomic convergence for SEE6 countries and the case of Macedonia, EU membership requires convergence of the Macedonian economy with that of the EU in realistic conditions, indicating income per capita and economic structure, and in nominal terms, meaning convergence of prices, inflation and interest rates.[1]

**Keywords:** *European Union, EU convergence, EU accession, SEE6, Macedonia, economic growth, exchange rate regime, euro*

## 1. INTRODUCTION

[1] SEE6 countries are: Macedonia, Serbia, Bosnia and Herzegovina, Montenegro, Kosovo, Albania



*ISSN 2076-9202*

According to literature, the macroeconomic policy of the new EU member states is facing two main challenges. The first is to manage the continued and rapid process of future real economic convergence, which will come with high real GDP and productivity growth rates, and large capital inflows. The second challenge is to achieve the degree of nominal convergence required to enter into European Monetary Union (EMU). These two challenges are not unrelated, such as rapid growth and large capital inflows can overburden realizing of nominal convergence, i.e., there are good reasons to assume that the real convergence would be easier to manage in some countries, if they were allowed to adopt the euro immediately. Both challenges are mainly associated with fiscal policy: managing capital inflows- because fiscal policy can absorb some of their demand effects, and nominal convergence- because the sustainability of public finances is part of the requirements for entering EMU.

## 2. MACROECONOMIC CHALLENGES FOR COUNTRIES OF SOUTH-EASTERN EUROPE

A survey provides an interesting overview of progress with real and nominal convergence in Central and South-Eastern Europe and the macroeconomic challenges that they face on their path to the EU (Schadler et al., 2005). Namely, referring to the macroeconomic stability and progress in transition both are closely related and both are important for sustainable growth and progress towards a functioning market economy. Progress with structural reforms can help for macroeconomic stability, for example, by reducing the structural external deficits. Also it helps the nominal convergence, as the productivity realizes the improvement of competitiveness and helps disinflation by maintaining low unit cost. In a study describing experiences about the development in the newest EU members, Fidrmuc shows that the development in



ISSN 2076-9202

more successful transition countries reflects higher total factor of productivity than the growth in relative levels of capital and labor (Fidrmuc, 2004). This underlines the importance of market-established reforms for development. Various indicators show that the most of the Southeastern countries require continual progress in transition reforms to become functional market economies. In regards to structural reforms, if they remain slow, positive growth rates seen in the last five years in many South-eastern European countries may not be sustainable. This would slow down real convergence. Initial reforms-like trade and price liberalization, privatization in many countries, and relative macroeconomic stability-facilitated lessened development since 2000 in many countries in the region.

## 3. IS THE REAL EXCHANGE RATE A POLICY VARIABLE?

Like many countries in the early stages of transition, South-eastern European countries rely mainly on exchange rates to reduce the inflation. In many countries, exchange rate helps to reduce the inflation to lower single digits since 2004. Albania’s managed float and informal inflation targeting were also successful in keeping inflation low, while in Romania, inflation, although declining under the managed float, remains close to double digits. Since 2000 Serbia has shifted between nominal and close to real exchange rate targeting (with important regime shifts in early 2003 and 2005) (De Grauwe and Schnabl, 2004). Inflation first declined with the exchange rate anchor, but an increasing external deficit prompted a shift to a managed float in 2003. However, inflation resurged, as suppressed administrative prices were readjusted and growing euroization contributed to an increased pass-through from the exchange rate to prices. The regime shifts may also have adversely affected monetary policy credibility, as indicated by the



ISSN 2076-9202

growing euroization. The exchange rate anchors and sluggish structural reform put pressure on competitiveness. Fixed or nearly fixed exchange rates can lead to unsustainable real appreciation and loss of competitiveness, unless fiscal and incomes policies remain tight and structural reforms boost productivity. For example, in Serbia, the exchange rate anchor in 2002 became unsustainable as large real wage increases and slow structural reforms eroded competitiveness and increased the external deficit. Pressures for real appreciation in the region also arise from the large inflows of foreign currency. The evolution of EU export market shares also suggests that Macedonia may have lost competitiveness, while most others have increased their share in the EU market. The real effective exchange rates data (REER) show a large appreciation in Bulgaria, Romania, and Albania in recent years, which at least in the former two is likely to reflect changes in market fundamentals in terms of increased productivity. In the remainder of the SEE, there is no clear trend with real appreciation and the REERs have remained relatively flat in the past few years.

South-eastern Europe can draw experience from recent new EU member states with monetary framework during accession. Exchange rate regimes during accession had shown different variations, which indicate the importance of fundamentals and associated policies in the implementation and achievement of macroeconomic stability (Schadler et al., 2005). Some of the largest recent EU members gradually moved from exchange-rate-based stabilizations to more flexible monetary policy as transition progressed. South-eastern Europe has much lower speed of reforms and lower growth rates. Related to this, capital inflows to the region are much smaller and have shown greater dispersion between countries.

Regardless the exchange rate regime, the appreciation of the real exchange rate among countries in the



ISSN 2076-9202

region is significant, although it is slightly lower when compared to countries in the EU member states. As a result, these countries suffer from loss of competitiveness. This can be clearly seen from the movements of the deficit on their current account, which are important in all these countries. For example, the current account deficit in 2007 ranged from 3.1% of GDP in Macedonia to 36.2% of GDP in Montenegro (European Commission, 2007). Using the exchange rate as well as the inflationary expectations has been effective so far, producing a low and stable inflation rates. In terms of high import dependence and the relatively slow implementation of structural reforms realized in increased export potential, contributed to the importance of high trade deficit, which was largely financed by high private transfers (Dauti and Pollozhani, 2008).

## 4. ANALYSIS: MACEDONIA'S FULFILLMENT OF ECONOMIC CRITERIA: CURRENT SITUATION

The EU agenda remains strategic priority for Macedonia. To cope with competitive pressures and market forces within the Union in the medium-term, the country needs to address important challenges through determined implementation of structural reforms. The economic recovery continued to progress, but it remains narrowly based on the external sector, and has had limited impact on unemployment which remains high especially among young people. Financial stability was preserved and FDI inflows increased. Fiscal discipline as well as transparency and quality of government spending deteriorated. Prospects for growth and employment depend largely on the business environment of the domestic private sector. A better alignment of workers' skills with labour demand needs to be tackled through



ISSN 2076-9202

further reforms of the education system, including the implementation of the vocation training strategy. Regarding public finances, the renewed deterioration of fiscal discipline in 2013 and 2014 calls for improved budget planning procedures and better consistency of annual budget execution with the medium-term fiscal strategy (Sedelmeier, 2006). The quality of public spending should be improved, by shifting the composition of capital expenditure towards growth-enhancing investment. Monetary policy remained successful in defending the currency peg. The inflation environment remained benign, creating room for monetary policy to stimulate sluggish credit growth. The increase in the consumer price index (CPI) averaged 2.8 % in 2013, down by about 0.5 percentage points since 2012 and fell further in spring 2014, mainly due to declining prices for food and housing and utilities (NBRM, 2014).

## 5. DISCUSSION: MACEDONIA'S CHALLENGES TO EU ACCESSION

The performances of the real convergence of Macedonia lag seriously compared with the new member states. Although GDP growth is accelerating in Macedonia in the past few years, in comparative perspective Macedonian inability to maintain rapid convergence of GDP per capita with EU countries, is a source of concern (Holtemoller, 2005). Given low Macedonian GDP per capita, realizing real convergence in per capita income is increasingly important matter. Macedonia has suffered from regional instability and domestic disturbances, as other new members also faced with economic and financial crises (Bisev and Petkovski, 2003). The growth of capital stock is a key component of real convergence to new Member States, because the ratio of investment to GDP is higher in most of those new member states, which ranges between 35% and 25% of GDP.



ISSN 2076-9202

The investment rate of Macedonia is on average less than 20% of GDP, which made the per capita income convergence with the EU impossible, through the growth of the capital stock. If Macedonia isn't able to increase the share of GDP and to devote at fixed capital formation over 25%, will be forced on fully devoting for productive gains, thus to be with the level of income per capita of other EU Member States. As of reports about economic policy it is clear that In January 2014, the authorities submitted the eighth Pre-accession Economic Programme (PEP), outlining key economic, fiscal and structural reforms for the period 2014-2016. Its macroeconomic and fiscal framework is somewhat optimistic with gradually increasing growth averaging close to 4 %, driven by domestic demand, and a gradual reduction in the general government deficit ratio to 2.6 % in 2016. Further efforts will be needed to improve the business environment, in particular market exit procedures and access to finance. The political consensus on the fundamentals of a market economy was maintained, but economic policy and public expenditure management remain driven by ad hoc concerns rather than the long-term requirements of the economy.

Analyzing macroeconomic stability, the current account deficit narrowed in 2013 to 1.8 % of GDP, as the merchandise trade balance improved in spite of a drop in current transfers. In the same period, foreign direct investment (FDI) inflows strengthened– in 2013, they accounted for 3.5 % of GDP, and stayed at the same level in the first half of 2014. In 2015 pick-up in export activity is expected, when the new capacities are taking up operations. Output growth needs to be more broadly based, and external imbalances are likely to widen again temporarily in view of investment-related imports. It is important to mention that many of the larger rates of the capital formation in the new member states is due to high



ISSN 2076-9202

levels of corporate savings and capital inflows, mainly in the form of FDI rather than result of high domestic personal savings. Thus, the low level of FDI in Macedonia is a reason for short-term decline in capital formation. Another barrier for investment - which carry growth - is domestic "investment deficit", which is mainly due to poor profitability and savings as the investment behavior of Macedonian companies too. Thus, the overcoming the low propensity for investing by the Macedonian firms is particularly important for real convergence (Habermas, 2012). Macedonia differs from the new Member States not only because of its low level of capital formation but because of its different dynamics of total factor productivity as well. Because of the capital accumulation in Macedonia some minor contributions for development were recquired, such as changes in employment and in total factor productivity growth, which were the main driver of GDP growth as well, from one year to another. To formulate effective policy it is necessary to research the growth of total factor productivity in Macedonia, as well as the causes of low business investment. The other elements of the structural convergence are the movement of labor and economic activities, generally from agriculture to industry and services. In all transition economies this structural change is an ongoing process and it is a part of the international routes where all countries experience a shift in economic activity from agriculture to manufacturing and then from agriculture and manufacturing to the services, as the income per capita is increasing (Edwards, 1998). Labour market conditions improved marginally, but remained challenging. The unemployment rate fell gradually, to 28.2 % in the second quarter of 2014, from an average of 29 % in 2013. Reforms to tackle the structural rigidities of the labour market have made only limited progress. The employability of



ISSN 2076-9202

workers should be improved through structural measures as well as through better targeting of the active labour market measures (Joseph and Hitchner, 2008).

Macedonian industrial value of added share is declining faster than in the case of new Member States, and in Macedonia's case, this structural change occurs with small convergence in per capita income. EU Membership can improve the industrial situation in Macedonia only if the access largely makes Macedonia a location from which foreign investors can serve the EU market if the domestic industry, with the help of FDI can take the necessary change for its output, an issue explored in greater detail in the section of the industry.

## 6. PERSPECTIVES: ECONOMIC CONVERGENCE MACHINE IN SEE6

The main goal of National Bank of Republic of Macedonia is the maintenance of the price stability. In this manner the National Bank is committed to applying a strategy for maintaining stable nominal exchange rate against the Euro. The role of the exchange rate as a nominal anchor derives from the characteristics of the domestic economy, as a small and open economy that is highly dependent on the import of primary commodities (European Commission, 2007). Also, Macedonian exchange rate can be used as an instrument for export performances of the country.

Macedonian policymakers should create policy with several aims focused on exchange rate policy because:

- A competitive real exchange rate provides an incentive for exports



ISSN 2076-9202

- The impact of exchange rates on trade should be seen in the context of continued integration of supply chains
- Exports generally include high import content and impact of foreign currency-exchange appreciation or depreciation on any finished product because it is complex. If the depreciation of the exchange rate makes its exports of finished products "cheaper", it makes imported components "expensive" for domestic producers.
- Maintaining growth and reducing the unemployment in a small and open economy such as Macedonia depends from improved performance of exports.
- Improving the performance of exports can help to preserve macroeconomic stability by closing the gap in the current account to avoid wasting supplies and to stop the growth of external debt.
- Improving performance requires improving export competitiveness.
- An outward oriented, market-friendly trade regime, which emphasizes the dismantling of import controls and tariffs (permitting access to inputs at world prices), and streamlined bureaucratic procedures, *i.e.* export and import procedures, modern customs administration and efficient value added tax administration will facilitate exports, including from SMEs.

Given the high openness of the economy, the risks to the projected growth continued to result from the global environment and developments in the external environment. By the end of 2015, the credit growth was projected to accelerate and it reached 8.5%. Despite the moderate deterioration on the current account, it is estimated that its negative balance is fully financed by capital inflows, mainly coming from foreign



ISSN 2076-9202

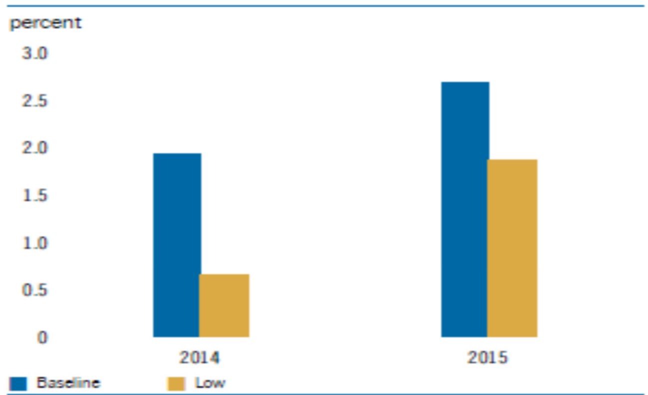
direct investment and external borrowings for infrastructure projects. In 2015 the foreign direct was gradually increased about 4.5% of GDP, respectively. The fiscal policy is important factor that influence the monetary policy setup, while the adequate coordination of these policies is crucial for creation and maintenance of the macroeconomic stability. After the risen level in 2013, the budget deficit fall gradually and it ranged about 3% of GDP on a medium run.

SEE6 growth in 2015 accelerated to 2.6 percent on average. All six SEE economies are expected to contribute to the increase in growth rates as external demand firms up and domestic demand begins to recover. Albania, Bosnia and Herzegovina, Kosovo and Serbia had higher or the same growth in 2015 than in 2014. In 2015, SEE6 economies grew slightly slower than the average for the EU11 countries (2.6 percent compared to 2.7 percent growth for EU11). The external and domestic risks, if materialized, will affect negatively the prospects for growth in the SEE6 countries and slow the nascent economic (Figure 1) (IMF, 2012b). In an extreme case of major deterioration of economic conditions driven by the materialization of above risks, SEE6 output growth in 2014 would less than half (to 0.6 percent) of the baseline projection (of 1.9 percent). In 2015, growth dropped by a third (to 1.7 percent) from the baseline (2.6 percent).

Figure 1: SEE6 Real GDP Growth Rate under Baseline and Low Case Scenarios



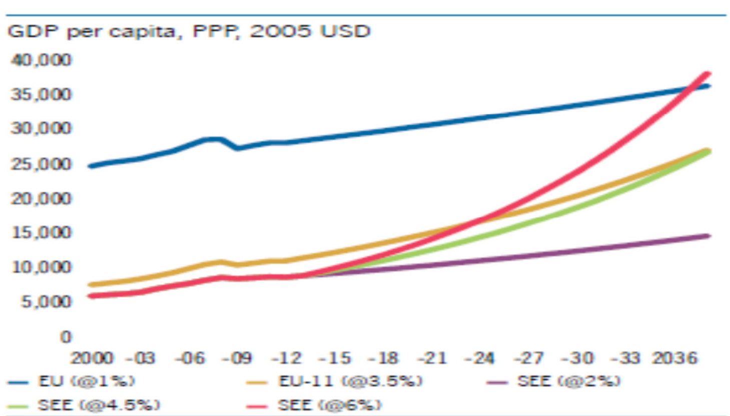
ISSN 2076-9202




*Source:* World Bank staff.

A recent analysis focuses on EU member countries and shows that expanding the growth potential through structural reforms in a stable macroeconomic environment drives strong income convergence.Translated to the SEE6, it means that removing structural rigidities in the macroeconomic policy mix, increasing global integration, improving the economy's productive potential and competitiveness, enhancing skills and labor productivity, and strengthening institutions would ultimately contribute positively to income growth and convergence.

Figure 2: Income Convergence




*Source:* World Bank staff.

Boosting incomes in the medium to longterm with the aim of converging with EU standards will mean



ISSN 2076-9202

not only maintaining the pace of reforms—but also converting reforms benefits into robust and equitable economic growth. Both of these are proving challenging. The reform pace appears to have slowed during the financial crises. Countries will need to take advantage of the economic rebound to relaunch the reform and convergence processes. There is evidence suggesting that improvements in the business climate should be broad rather than targeted toward specific sectors, as growth and employment creating firms tend to be young and dynamic, but not concentrated in any particular sector. Improving trade links in terms of logistics, institutions and regulations will be important to take advantage of the EU market. In addition, governments need to provide reliable and streamlined processes that guarantee EU safety standards are met for exporting firms, particularly for agricultural exporters. Improvements in governance standards—including the rule of law—will be closely linked to the EU integration process. But reforms required by the EU will also help to boost economic growth in SEE countries. Such reforms are essential to boost labor demand, reduce unemployment, address the challenges driven by demographic changes and improve prosperity for all in SEE6. Increasing employment is essential to reduce poverty and to bring about shared prosperity in SEE6. Since the major source of income for most households is through selling labor, increasing employment opportunities and ensuring that workers have the skills necessary to take advantage of these opportunities are essential to increase the income generation capacity of the entire population.

## 7. CONCLUSION

What are the results of conducting reforms for speeding up the economic convergence? As of the analysis



ISSN 2076-9202

it is shown that large potential gains could be reaped from structure reforms. Reports identify that in ten years the Euro-area GDP could be around 6% higher if Member States adopt measures to halve the gap vis-a-vis the average of the three best-performing Member States in each of the reform areas considered. When the structural reform will be successfully implemented, it seems promising to the growth of the economy. Growth effects are significant and higher growth potential can also stimulate investment demand and help to restore investment to pre-crisis level. Analyzing reforms it could be noticed that reforms that labour force participation yield the largest output effects in the short to medium run. Reforms relating to product markets can lead to large output gains. Structural fiscal reforms that shift the tax burden away from labour towards less distortionary taxes could be implemented relatively rapidly and boost employment and growth already in a short to medium run. Differences across countries mainly reflect where a country stands relative to “best performance” for different structural indicators. Performance gaps are particularly large in participation rates and tax structures, and reforms in these areas can deliver the largest effects. There are positive cross country spillovers of structural reforms, adding up to 10% to the gains in output in the long run. The demand effect boosts imports and supports trading partners’ growth, though this is partly offset by the competitiveness effect. Trade balance effects are relatively small and can turn negative where the demand effect dominates the competitiveness effect. Reforms lead to significant improvements in fiscal positions and can yield sizeable reductions in debt-to-GDP ratios in the medium/long term, alleviating the need for further consolidation measures and contributing to long-term debt sustainability.



ISSN 2076-9202

How could Macedonia reach and sustain higher rates of economic growth thus speeding up the process of economic convergence too?

The research offer options that include increase of the labor contribution to economic growth by raising labor participation and reducing unemployment. The second option refers to the improvement of allocative efficiency. This considers promotion enterprise restructuring and reforming product market regulation as including regulation in the infrastructure sector. Next option is focused on deepening trade integration by promoting export-oriented FDI and developing the supply of exportable goods, meaning that Macedonia would need to integrate its logistics infrastructure. Accelerating the process of economic convergence will be supported by fostering technological progress. The recommendations are focused on policy-makers, inviting them to identify what policies are politically feasible and to be checked for their consistency with the overall objective of raising and sustaining economic growth. Next, these strategies need to generate institutional requirements that are commensurate with the existing institutional endowment of Macedonia. This will lead to a near-term focus on deepening trade integration and fostering innovation, while measures related to expanding labor participation and employment could be adopted more gradually with a long-term perspective. These measures would better position the country to fully benefit from EU Accession and to better manage the effects of the global financial crisis, by strengthening Macedonia‘s international competitiveness. In addition to the policy measures directly recommended for deepening trade and fostering innovation, the following complementary policy initiatives would be required:



ISSN 2076-9202

- Advancing *enterprise restructuring* (privatization) and the promotion of stronger *market competition* (improving product market regulation and de-regulation).
- Adjusting the *life long learning system* to market needs, encouraging *labor training* by firms, and improving the supply of (selected) skills by possibly reviewing *migration rules* for labor market segments where the skills-gap is binding.
- Political resistance to the trade and innovation measures associated to the proposed strategy is likely to be comparatively low, with the exception of enterprise restructuring efforts. C*ompensatory policies* for workers negatively affected by enterprise restructuring should be considered.
- Preliminary evidence on the positive association between access to non-banking finance and total factor productivity suggests further examination of the role of non-banking financial institutions in the selection of investment opportunities and thus in fostering growth in Macedonia.

Summarizing, there are starting points to introducing high integration for structural adjustments and growth:

- faster productivity and quality catching – up
- faster wage catch-up
- faster upgrading of commodity structure leading to a faster disappearance of asymmetries in income and price-elasticity
- impact on invisible and income accounts: increased trade and transport services (balance impact neutral); increased tourism in both directions; increased deficits in other services (here lies one of EU's comparative advantages; more personal transfers)



ISSN 2076-9202

- impact on capital movements: increased FDI and portfolio investment; easier access to credits and better conditions for debt servicing
- greater pressure towards reducing the “undervaluation” of the national currencies: speed up of institutional changes and market functioning will increase convergence of price structures; additional pressure to achieve a higher level of international purchasing power because of greater tourist flows and increased imports; additional pressure to achieve monetary stability and use of the nominal exchange rate as an anchor with the view of approximation to the Maastricht criteria
- greater openness of EU market.

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